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Special bulletin no. 04 (1920, July); Moving pictures; Mining company; Merchandise in transit; Cotton mills; Automobile insurance

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SPECIAL BULLETIN No. 4

July, 1920

[*The Committee on Administration of Endowment authorizes the publication of special Bulletins, of which this is one, on the distinct understanding that members are not to consider answers given to questions as being official pronouncements of the Institute, but merely the individual opinions of accountants to whom the questions were referred.*

It is earnestly requested that members criticise freely and constructively the answers given in this or any other Bulletin of this series.]

MOVING PICTURES

Referring to Special Bulletin No. 3—Moving Pictures, the following comment is offered:

STUDIO BUILDING:

The memo in Bulletin No. 3 states that if "of steel construction raised on a substantial foundation, with glass roof and sides," the annual rate of depreciation allowable would not be over 2 per cent, probably not over 1 per cent. Cost of breakage is too small to consider; very little occurs.

As studios become obsolete within a short period, as the mechanical work for changing lighting (which is part of the building) is soon worn out, as the establishment of a studio does not raise the value of land and surrounding property as a factory does, as no moving picture studio has ever remained in use for fifteen years, as a studio building is almost valueless for any other purpose, as changes in studio buildings are invariably made upon the engagement of a new general director of production, and as the rate given indicates a probable useful life of fifty to one hundred years, it needs correction. A moving picture studio one hundred years old is imaginable only to one who has no knowledge of the business. At least 3 per cent should be allowed.

Wooden studios are given 10 per cent to 15 per cent. But none has ever lasted ten years.

Finally, there are now only five or six film companies in the U. S. A.

that have been producing negatives for ten years. Others have gone out of business, their studios destroyed or rebuilt for new owners.

The treatment of scenery cost advocated in Bulletin No. 3 is correct.

WARDROBES:

Wardrobe should ordinarily be charged against the production for which it is purchased. Occasionally a large quantity of uniforms may be got for a great spectacular picture, and there may be a considerable residual value. In such cases, charge to the production the whole cost, have a survey of what is left when the picture is finished, credit the value of the residue to the cost of the picture and charge to wardrobe account. This is the origin of the asset account "Wardrobes."

At the end of each year a survey of wardrobe on hand should be made and an adjustment of value set up for it, debiting or crediting the wardrobe account according to whether wardrobe on hand exceeds or falls short of book value. Furniture bought for specific negatives should be treated in the same way as the costumes. Such furniture is radically different from ordinary furniture purchased for regular use.

MANUFACTURING EQUIPMENT:

Directors never have anything to do with manufacturing equipment, as defined in the question. The life of the machines principally in use are, approximately, as follows:

Perforating machines	5 years
Printing and developing	8-12 years
Tanks (chemical vats)	Not much used in modern plants. If wooden, 8-12 years. If slate, will not be physically worn out within any reasonable period
Automatic printing and developing machines, built in, need occasional renewal of parts. Main machine may last	20 years

Generally a rate of 10 per cent per annum on light machinery and 6 per cent on heavy machinery has been found proper; the light machinery referred to being perforating machines, printing machines, small developing machines and the wooden frames and tanks used in small factories for developing.

Heavy machinery includes power plant, pumps, slate tanks and the larger developing machines.

The equipment with which directors have to do, and which seems to have been contemplated in the answer in Bulletin No. 3, consists principally of lighting apparatus, cameras, ladders, automobiles, properties and other articles used in the studio but not in manufacturing. Properties are not to be charged off by depreciation. The amount charged off should appear as "cost of props," classified in the same way as cost of wardrobe. The remaining articles of equipment are best treated as outlined in Bulletin No. 3. By "properties" is understood—guns, swords, spears, clubs, badges, fishing rods, torches and similar articles which are not "wardrobe." The "swan" in Lohengrin is a property. If a film of Lohengrin were made, the swan would probably never be of use again, although mechanically perfect. Hence the propriety of considering its cost as part of the cost of the picture.

Reply:—The opinion of your correspondent is, it would seem, substantially in agreement with our views in the matter except in the case of the depreciation of the studio building and of manufacturing equipment.

STUDIO BUILDING:

Your correspondent has apparently overlooked the fact that the question asked was as to what depreciation would be allowed by the internal revenue department on moving picture properties. I quite agree that provision should be made for obsolescence where obsolescence actually exists.

I do not, however, believe that the facts that the establishment of a studio does not raise the value of the land or surrounding property, that no moving picture studio has ever remained in use for fifteen years, that a studio building is almost valueless for any other purposes, or that changes in studio buildings are invariably made upon the engagement of a new general director, will be considered by the government as good and sufficient reasons for granting an allowance for what, in my opinion, is economic obsolesence.

It is true that there are no moving picture studios which have been in existence one hundred years at the present date, but your correspondent has evidently lost sight of the fact that the moving picture industry is only in its infancy, and the same statement might correctly be made with reference to numerous other manufacturing industries of the present time.

Many manufacturing plants are to-day depreciating equipment over a normal life of ten years, although there is every probability that such equipment will be discarded long before the period of its useful life due to obsolescence resulting from modern inventions ends. Yet the government will not allow additional depreciation on such equipment based on such probabilities.

MANUFACTURING EQUIPMENT:

The depreciation suggested by your correspondent is, in my opinion, reasonable. As stated, the equipment which I contemplated in my answer in Bulletin No. 3 was such equipment as is used in the studio, to which I understood the original question more particularly applied.

MINING COMPANY

In accordance with your request for criticism on any answers given in your bulletin, I write to object to the treatment of the mining problem in Bulletin No. 2, page 7.

If the capital stock and the mining lands are correctly shown at $1,000,000, respectively, as is undoubtedly correct, the treasury stock should also be shown at its nominal value of $500,000. The value of the treasury stock per share is no more and no less than the value of the original issue. The proper entry should have been to debit treasury stock $500,000, and to credit working capital with the same amount. The reason for this is that the stock was donated for the purpose of raising working capital.

If the treasury stock had sold at par, the working capital would also have represented par. As it sold at a discount, the discount is a diminution of the working capital. The result of this is that on December 31st, 1917, the balance-sheet would show capital stock "short" $1,000,000 less treasury stock $340,000, the net outstanding stock being $660,000; working capital would show a credit balance of $380,000. Reference to the figures published in the problem discloses outside liabilities of $20,000. These credit balances amount to $1,060,000, which is the total of the debit balances.

The balance of working capital account is made up of the treasury stock unsold, $340,000, and the $40,000 of cash received for the stock sold. When all the stock is sold the working capital account will represent exactly the amount of money received from the sale of treasury stock. The final disposition of this account is in the hands of the board of directors. The logical procedure would be to charge against it the items of pure expense incurred during the development work, and to credit the remainder to mining land account.

If the item of profit and loss, $10,000, is meant to be the amount spent for necessary expenses during the development of the mine, the amount should be charged to development expense, which should be carried as a deferred charge, to be eventually written off against working capital.

In reply to your letter of April 20, enclosing a criticism of the solution of the mining problem, as given in the Institute's Bulletin No. 2, we submit the following:

The objector bases his criticism largely upon the hypothesis that the value of the stock is definitely fixed at par by reason of the valuation of the property by the directors, stating that, therefore, the treasury stock must be valued at par. In the controversion to this assertion it may be stated that the directors, in placing a valuation on the property equivalent to the par value of the stock issued therefor, do not put themselves in the position of declaring the cash value of the stock, and it is well recognized in practice that there may be no direct relation between the valuation of property for stock-issuing purposes and the cash value of stock thus issued. The obvious purpose of the issue of such stock for property, the value of which has been fixed by the directors, is to make the stock full-paid and non-assessable, so that it may, if donated to the company, be sold at any price, or given away, without making the holders liable for any assessment.

The second fallacy in the solution proposed by the objector is, that until such time as the entire amount of donated stock is disposed of, the company would be shown to have an inflated "working capital." As a matter of fact, the term "working capital" is well understood to be synonymous with net current assets; and certainly no one would regard as a current asset 340,000 shares of treasury stock valued at $1.00 a share when the maximum price at which such treasury stock has been sold is twenty-five cents a share.

In the report of the special committee on accounting terminology of the American Association of Public Accountants, published in the 1909 year book, appears the following definition of working capital:

"That portion of capital used in the active operations of a business. It may consist of (a) capital stock subscribed and paid. (b) Capital stock sold to stockholders to raise cash. (c) Dividends or surplus undistributed. (d) Part of purchase money of business allowed to remain unpaid. (e) Loans from bank or otherwise. (f) Proceeds of accommodation notes.

(g) Proceeds of sale of bonds. (h) Assessment on stockholders. Am. Enc."

This idea regarding the meaning of working capital prevails in virtually all discussions of the subject. Mead, in his book on "Corporation Finance," states, "Every new enterprise needs working capital, and the financial plan must provide for this. A portion of the proceeds of the securities of the new company must be put in the treasury to serve the current needs of the corporation," and again, "The working capital of the company, its cash, materials and bills receivable, varies with the volume of its business."

The objector is attempting to give financial significance to the term "working capital," when as a matter of fact any term so employed should only be considered a title for an account, which may be carried on the books as an offset to a treasury stock debit account.

To sum up, regardless of whether unsold treasury stock be carried as an asset at par or be deducted from the stock issued, the effect would be to inflate the assets; it makes no difference whether the offsetting credit account be entitled surplus or working capital. In such cases there is no good reason for, and there are many reasons against, valuing donated stock at a figure in excess of the price for which it can be sold.

MERCHANDISE IN TRANSIT

Q. A wholesale house, located west of New York, deals largely in wearing apparel manufactured in the East. Purchase terms are F. O. B. shipping point. The fiscal year closes on December 31st, and the company has steadily followed a practice more or less prevalent in the trade of not taking up in its inventories and, per contra, in its liabilities, the goods purchased for the following spring season. In past years this has not been especially important, as only a comparatively small proportion was in transit and few goods were actually received and on hand. On December 31st, 1919, however, the purchases in transit, or actually received, amounted to $121,000, whereas the trade creditors' accounts per books amounted to only $3,000. In a certified balance-sheet which we prepared we included both the asset and liability, and as a result the ratio of current assets to current liabilities was 1.77 to 1.00 instead of 3.00 to 1.00, the usual showing for this corporation.

We were then asked by the note brokers handling the paper of the company to exclude the $121,000.00 from the figures and show it as a foot-note on the balance-sheet. They stated that this was the usual manner of treating items of this nature. This we refused to do, our reasons being: (1) that part of the goods had been received and were actually in the company's premises, although still in original cases, and (2) that the goods not received were nevertheless the property of the company, subject only to the remote possibility of the rejection upon receipt and examination.

We are aware of the fact that some large accounting firms treat liabilities of this nature as foot-notes, and this undoubtedly influenced the note brokers, but we feel that our position was proper. However, we do not wish to lean backward in our anxiety to prepare statements according to the best practice, and we should like very much to receive an opinion from the Institute. We have no doubt as to the correctness of including the liability for goods received, and we are of the opinion that goods in transit purchased F. O. B. shipping point should likewise be included as the only reason for not taking up the latter (that the goods have not been examined) can likewise be advanced in connection with the former when still in original packing cases.

A. In the case of a strictly seasonal business, in which it is the practice to clean up, as far as possible, the merchandise of one season before becoming actively engaged in the operations of the following season, it would seem, from a practical standpoint, that the banker or other creditor would be furnished information regarding the accounts in the most useful form, if the statement showed the condition that obtained at the end of one season before introducing factors which affect the season about to begin.

Very frequently, as appears to have been true of the company mentioned, the receipt of mercandise for the spring season does not take place until after the merchandise of the fall season has been disposed of and the books have been closed. In such a case, there would be little merchandise in transit and few goods actually received and on hand at the closing of the books, if the date selected for closing occurred midway between the two seasons.

A statement from the books as of that period would therefore be most informing to the banker or other creditor, because it would show the extent to which the company was able to clean up at the period of lowest stock and presumable least amount of liabilities.

Owing to the extraordinary conditions which have prevailed during the last few years, both as respects the manufacture and delivery of merchandise, it has frequently been necessary to contract for and receive the merchandise in accordance with the desires of the seller and not the immediate needs of the purchaser. This was apt to cause a condition such as obtained in the case mentioned, in which a company ordinarily having little merchandise in transit or on hand at the close of its season, found itself with a large volume of merchandise bought for the season to follow.

In a case of this kind it does not seem to me that, from a practical standpoint, it is reprehensible or bad accounting practice to show the merchandise bought for the spring season as a foot-note, assuming that the character of the item and the amount involved are stated clearly. It should be done as a rule in the case of seasonal businesses only where such a condition would ordinarily not obtain and would be justified on the ground that by presenting the statement in this manner it conveys the information regarding the company's accounts to the banker or other creditor in a form comparable with what they had been receiving before, and stated in a manner which, in effect, represents the true status as to the ratio of current assets to liabilities under any conditions except abnormal ones.

In prior years, even though the merchandise had not been received, it doubtless had been ordered, and while, theoretically, there may not have been a present liability there was, as respects the purchase orders, practically the same liability as in the later years except that as to the latter period the liability was expressed in terms of the actual purchase invoices. It might also be pointed out as to goods in transit, that while they may be, in effect, the property of the purchaser, there is, I believe, some legal procedure possible whereby delivery may be stopped and they may be reclaimed by the seller. They are therefore not in precisely the same class as merchandise actually on hand.

I recognize that from a purely theoretical and technical standpoint it might be claimed that if the title to the merchandise has passed to the purchaser, then the merchandise should appear as an asset, and if not paid for the equivalent amount should be included among the liabilities. I believe, however, that the present requirements of correct accounting practice are complied with, if in special cases a notation is made showing clearly the character of the items and the amount, if this information is stated on the balance-sheet in such a manner that it cannot possibly be overlooked or its significance fail to be appreciated by anyone who scans the statement.

I might say that generally it is our practice to add the amounts to both sides of the balance-sheet, in each case not merging the items with similar items on the balance-sheet, but stating them separately. Only where the business is virtually of a seasonal character do we consider it good practice to deal with such items in the form of a notation on the balance-sheet.

COTTON MILLS

Q. We are anxious to obtain some information regarding the fixed investment of cotton mills, also the average rates of depreciation.

We should like to have, if possible, the cost of the land separately from the cost of the buildings, machinery and equipment.

The information, both as to cost and depreciation, should be shown separately for:

Mills operating spinning plants only.

Mills operating spinning and weaving plants.

Mills operating spinning, weaving and dyeing plants.

A. It is practically impossible to return any but a very general answer to these questions, and the replies that I give are based upon my observation of the records of mills already built and operating. Taking them as a type, a spinning mill running on 25's yarn, the fixed investment of land, buildings and machinery and equipment at a 100 per cent, the machinery and equipment, etc., would be about 50 to 60 per cent of the total, the buildings about 40 or 50 per cent of the total and the land value almost a negligible percentage.

If this mill were a spinning and weaving plant the percentages would not differ very radically.

There is no direct relation, or not necessarily so, in the cost of a bleachery and dye works to the fixed investment of a spinning and weaving plant. It should be considered, and generally is, as a separate investment. Some mills operating bleacheries and dye works, bleach and dye the product of other mills as well as their own.

In considering land values of cotton mills it must be remembered that the actual area occupied by buildings is very small. Five acres perhaps would provide space enough for all the buildings necessary to house the machinery equipment, supplies and materials of a large plant. Many mills have much larger land holdings upon which one- or two-story tenements are erected for the mill operatives. This, however, is not considered as mill buildings. While perhaps a necessary investment to provide homes for the operatives, it is almost always a separate investment and generally brings in a fair return in profit, through rentals charged and invariably collected by deductions from payroll.

A large proportion of cotton mills in the southeastern states are situated in rural sections. When they were projected, as an inducement to locate in certain sections, land was given them. Or if not given them, the price paid was very low, and as stated previously, the percentage to the total plant value is negligible. When this is not so, it will generally be found that the mill is located in or near some larger center of population. As an indication of low original land values, particularly in rural districts, there is hardly a cotton mill in the southeastern states which has been operating for the last five years whose land values have not sharply appreciated. Land has risen in value all over the southern states, but the greater percentage of increase in mill land is due to reasons stated. There are other reasons which have to do with the great increase in cost of some types of machinery over others manufacturing different kinds of cotton textiles, which, while taking about the same or less ground space, would tend to throw out of any fixed proportion the relative value of land to buildings and machinery and equipment.

AUTOMOBILE INSURANCE

Q. What is in your opinion

(1) the rate of percentage, based on the net premium income, of unearned premium for

(a) premiums on risks running one year or less;
(b) premiums on risks running more than one year?

An eminent British authority on insurance, Mr. Tyler, says: "Amongst insurance offices generally (other than life offices) there has for long been recognized a description of 'rate by common consent,' that the minimum necessary is 33⅓ per cent of the net premium income, i. e., the premium income after deduction of the sum paid away for re-insurance protection.

"Hence the adoption of a minimum reserve of one-third of the premium income, for the purpose of a general rule, is probably not so far removed from what it should be as at first sight might appear."

Thus Mr. Tyler believes that one-third of the premium income on annual insurance is sufficient approximately for unearned premiums.

Another British authority, Mr. Young, arrives at a reserve of 42.79 per cent, say, 43 per cent of the premium income on annual insurance.

In your opinion, would 33⅓ per cent be a fair rate? My clients claim it is too high.

A. It has been our experience that companies doing business in New York state reserve 50 per cent of the premium income after deduction of return premiums, cancellations and re-insurance, but before deduction of broker's commission.

The requirements of the state of New York call for a reserve of 50 per cent, say 43 per cent of the premium income on actual insurance. premium income, no deduction is allowed for re-insurance in respect of those companies which are not "admitted" by the state department as doing business within the state.